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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262

REPLY COMMENTS OF BELLSOUTH

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EXECUTIVE SUMMARY

In the FNPRM, the Commission sought comment on how it should respond to the remand of the *1997 LEC Price Cap Performance Review* order by the Court of Appeals. In its opening comments, BellSouth pointed out the limited nature of the issues remanded by the Court. BellSouth also demonstrated that of the three options spelled out in the FNPRM, only Option 1, reliance on the 1997 Staff TFP Study, was legally permissible. BellSouth recommended that the Commission adopt the CALLS proposal rather than rule on the potentially disruptive issues framed by the FNPRM.

In its comments, AT&T challenged BellSouth's interpretation of the law. In these reply comments, BellSouth demonstrates that AT&T is wrong. The Commission's rights and responsibilities are extremely restricted for the remand period. The evidence that the Commission may lawfully consider supports an X-Factor no higher than 4.86 percent. There is no justification for a Consumer Productivity Dividend based on the elimination of sharing.

The Commission has more flexibility to modify the X-Factor going forward. The Commission should do more than look at the historical record when predicting future LEC productivity gains. The Commission should recognize that much of the "low hanging fruit" has already been picked. For example, the large force reductions that were a primary driver of productivity gains in the early 1990s cannot be repeated. Furthermore, many of the Commission's reforms, such as adopting a more efficient rate structure for access charges, will make it harder for the LECs to achieve productivity gains in the future that match those of the past. The continuing growth of competition fostered by the 1996 Act also makes future LEC productivity gains more difficult and uncertain. As the historical sources of prior productivity gains are stripped away, the Commission should ask itself, "Why would we expect the price cap LECs to be able to outperform the competitive market firms in the economy as a whole by X percent year after year?" BellSouth recommends that the Commission adopt a more conservative X-Factor for the future.

Those parties supporting a higher X-Factor present little or no analytical support for their proposals. They simply label LEC earnings as "excessive" and then propose ways for the Commission to strip the LECs of those earnings and transfer them to the IXCs. BellSouth demonstrates herein that LEC earnings are not excessive, and the prospect of improved earnings is the engine that drives the success of price cap regulation.

MCI and AT&T attempt to reprise their call for an "interstate only" X-Factor. The support they offer, however, is both economically meaningless and contrary to the prior findings of the Commission and the Court. MCI and AT&T seem to believe they are entitled to all of the benefits that LEC price cap regulation has produced over the past decade. BellSouth demonstrates herein that, in fact, customers of the price cap LECs have reaped over 70 percent of the benefits that LEC efficiency has produced. The less than 30 percent that the LECs have retained in the form of improved earnings is a reasonable reward for their efforts.

Price cap regulation of the LECs has been a "win-win" for the LECs and their customers. The Commission should not attempt to tilt the playing field in favor of the IXCs and, in the process, destroy the very fabric of price cap regulation.

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BellSouth Corporation and BellSouth Telecommunications, Inc. ("BellSouth") hereby reply to the comments of other parties to this proceeding. Sixteen parties filed comments in response to the Further Notice of Proposed Rulemaking ("FNPRM").[1] Not surprisingly, there were widely divergent views regarding: 1) the Commission's rights and obligations on remand from the Court of Appeals; 2) the appropriate response to the remand; 3) the appropriate X-Factor for the remand period and prospectively; and 4) the inclusion of a Consumer Productivity Dividend ("CPD"), both for the remand period and prospectively.

The one area where every party who commented on the issue was in agreement, however, was that the Commission can and should avoid getting into the highly contentious issues in this case by adopting the plan submitted by the Coalition for Affordable Local and Long Distance Services ("CALLS").[2] The CALLS plan is a comprehensive approach to major unresolved

[1] Comments were filed by the Ad Hoc Telecommunications Users Committee ("Ad Hoc"), AT&T Corp. ('AT&T"), Bell Atlantic, BellSouth, Cincinnati Bell Telephone Company ("CBT"), Citizens Communications ("Citizens"), GTE Service Corporation ("GTE"), the General Services Administration ("GSA"), Independent Telephone and Telecommunications Alliance ("ITAA"), Iowa Telecommunications Services, Inc. ("Iowa Telecom"), MCI WorldCom, Inc. ("MCI"), Missouri Public Service Commission ("MoPSC"), SBC, Sprint Corporation ("Sprint"), the United States Telecom Association ("USTA"), and U S West Communications, Inc. ("U S West").

[2] AT&T at 2; GTE at 4; Sprint at 2, 5: "The [CALLS] plan takes much of that which is good in price cap regulation while applying the reductions to those elements that all acknowledge are furthest from their underlying cost. In doing so, it mitigates the need for cost showings and rate prescriptions."

issues in the Access Charge Reform, Price Cap, Low-Volume Long Distance Users and Universal Service proceedings. The plan was the result of extensive negotiation between the Interexchange Carriers ("IXCs") and the Local Exchange Carriers ("LECs"), and provides substantial benefits to the public. Indeed, as shown in BellSouth's opening Comments and below, the benefits to the public from the price cap portion of the plan alone are substantial, and will be lost if the Commission proceeds to a decision in this docket. If, however, the Commission does not adopt the CALLS plan, it must contend with the issues discussed below.

The Commission's Rights and Obligations on Remand.

In its opening Comments, BellSouth demonstrated that the Commission's rights and responsibilities for the remand period (July 1, 1997 until the effective date of a new Commission order) are severely limited.[3] Specifically, those issues decided by the Commission and either affirmed by the Court of Appeals or not challenged on appeal are now "final" and may not be relitigated by any party or the Commission.[4] Among the items that commenting parties attempt to reopen that are "final" for the remand period include the Commission's decision to base the X-Factor on total company productivity gains rather than "interstate-only" productivity gains, and the Commission's decision to "reinitialize" the X-Factor for only one year. BellSouth also noted that no party challenged the methodology employed in the 1997 Staff TPD Study or the series of

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[3] See BellSouth Comments at 13-14.

[4] See *Aeronautical Radio, Inc. v. FCC*, 983 F.2d 275, 281 (D.C. Cir. 1993): "ARINC's claim of improper dismissal was disposed of on final judgment, and was *not* subject to further reconsideration on remand. ARINC is therefore precluded from relitigating that claim." (Emphasis by the Court) citing *Federated Dep't. Stores, Inc. v. Moitie*, 452 U.S. 394, 398, 101 S.Ct. 2424, 2427, 69 L.Ed.2d 103 (1981): "A final judgment on the merits of an action precludes the parties . . . from relitigating issues that were or could have been raised in that action." With regard to the binding effect of a final judgment on the Commission, See *Greater Boston Television Corp. v. FCC*, 463 F.2d 268, 291 (D.C. Cir. 1971)("*Greater Boston*"): "[T]he Commission is bound to respect the governance of a final administrative decision for the particular matter there determined. Congress has given dominant weight to the public interest in repose that prohibits further administrative consideration for such a final order. This public

productivity measurements calculated using that study. The findings by the Commission adopting the 1997 Staff TFP Study and its calculations are likewise "final" and not subject to further reconsideration for the remand period.[5]

BellSouth cited 47 U.S.C. § 402(h) as authority for the proposition that the Commission is prohibited from considering new evidence on remand unless so instructed by the Court.[6] Section 402(h) limits the Commission's actions on remand to "carry out the judgment of the court" and unless otherwise ordered by the court "to do so upon the basis of the proceedings already had and the record upon which said appeal was heard and determined." The Court remanded three specific areas for "further explanation" by the Commission: the selection of 6.0% as the historical component of the X-Factor based on the 1997 Staff TFP Study, the retention of a 0.5% CPD, and the inclusion of the CPD in the Commission-ordered "reinitialization" of the X-Factor for one year. Those are the only issues remanded by the Court, and the only issues, which are properly before the Commission for the remand period.[7]

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interest – uncontrovertible for an order not appealed – has equal if not greater application, in our view, for an order that has been reviewed and affirmed on court appeal as without legal defect."

[5] BellSouth noted in its opening Comments that the Court during oral argument asked whether later historical data supported the "upward trend" that the Commission purported to find in the data from the 1997 Staff TFP Study. Both USTA and AT&T submitted Rule 28(j) letters to the Court. BellSouth Comments at 15. The Court did not expressly rely on these updates to reach its conclusion that there was no apparent trend in the data. Thus, it is a close question whether the Commission can rely on updated data to the 1997 Staff TFP Study for the years 1996-98 on remand. Based on the Court's raising this issue, BellSouth believes that such an update is permissible. However, the Court in no way opened the door to major revisions to the 1997 Staff TFP Study or consideration of new models by the Commission on remand.

[6] Section 402(h) of the Communications Act provides: "(h) In the event that the court shall render a decision and enter an order reversing the order of the Commission, it shall remand the case to the Commission to carry out the judgment of the court and it shall be the duty of the Commission, in the absence of the proceedings to review such judgment, to forthwith give effect thereto, and unless otherwise ordered by the court, to do so upon the basis of the proceedings already had and the record upon which said appeal was heard and determined."

[7] BellSouth noted that the Commission was free to conduct a FNPRM, and is free (subject to its duty to justify any changes in policy or methodology) to adopt new rules for the post-remand period.

AT&T challenges BellSouth's interpretation of Section 402(h). AT&T proposes that the Commission adopt a new methodology that was not before the Court and not noticed in the FNPRM. AT&T claims that "the Commission has ample authority to consider new data and to develop new methodologies when prescribing an X-Factor for the remand period, as well as for the future."[8] AT&T is wrong. AT&T fundamentally misrepresents the case it primarily relies upon to support its proposition. That case, when viewed properly, leads to exactly the opposite conclusion.

AT&T relies upon the D.C. Circuit's decision in *Eastern Carolinas Broadcasting Co. v. FCC*, 762 F.2d 95 (D.C. Cir. 1985)("*Eastern Carolinas*"). AT&T claims that the Court "expressly recognized the Commission's long-standing policy of allowing parties to submit updated data concerning remanded issues, and to make new determinations based on those data."[9] The Court did no such thing. In order to understand the Court's holding, it is necessary to review the background of the case.

In *Eastern Carolinas*, the appellant, doing business as WPDE, challenged the FCC's grant of construction permits for two "tall tower" television transmitters by competing broadcasters. On appeal in 1983, the Court upheld the FCC orders in almost all respects. However, it found that the FCC had not "adequately explained" why the alleged "cumulative impact" of the two otherwise separate proposals did not warrant a hearing under the Communications Act. The Court remanded to the Commission with instructions to provide "a sufficient decisional explanation with respect to its conclusions concerning cumulative impact issues. . . " With regard to a hearing, the Court stated:

[8] AT&T Comments at 16.

[9] AT&T Comments at 16-17.

> If, in the course of its deliberations, the Commission discovers that it is unable to offer a satisfactory justification for its finding of no cumulative impact or to make a reasoned finding concerning where the public interest lies in this case, it should order a hearing on the UHF impact issue.[10]

Shortly after the opinion was issued WPDE notified the Commission of its intent to file supplemental information dealing with the cumulative impact issue. On the day that WPDE submitted its supplement, the FCC issued an order rejecting the cumulative impact claim. The FCC stated that it could provide a rational analysis of the cumulative impact claim on the basis of the existing record. The Commission also found that Section 402(h) *required* it to resolve the remanded issue on the basis of the existing record.[11] The FCC asserted that Section 402(h) "deprives it of any discretion to consider the portion of WPDE's supplemental filing that presented new record evidence because this court's remand did not explicitly order the Commission to reopen the record."[12]

On further judicial review, the Court of Appeals expressly refused to rule on the FCC's interpretation of the statute. Instead, it found that the FCC's interpretation amounted to an unannounced change in prior agency practice:

> We need not decide, however, whether the agency's interpretation is right or wrong because we conclude that even if right it represented a radical change from prior agency practice on which the appellant could properly rely. Under the circumstances of this case, we hold that it was arbitrary and capricious for the agency to fail to provide notice of that change when such notice would not impede agency compliance with what it now regards as the law and would enable the appellant to take available steps to avoid the inequitable consequences of the sudden change.[13]

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[10] 762 F.2d at 97-98.

[11] 762 F.2d at 98.

[12] 762 F.2d at 99.

[13] 762 F.2d at 99.

The Court then cited the cases relied upon by AT&T in its comments to show that the agency had frequently allowed parties to supplement the record "without mentioning section 402(h)."[14] The Court did not challenge the Commission's interpretation of Section 402(h):

> The Commission nonetheless announced for the first time in this case that the Act prohibits post-remand consideration of new factual materials in the absence of a specific court order and that "the appropriate course would have been for the petitioners to obtain leave of the Court to supplement the record."
>
> . . .
>
> We therefore cannot endorse the FCC's reliance on section 402(h) to bar consideration of the updated evidence contained in WPDE's supplement. That reliance, even if legally correct, and even if legally required, was needlessly effected in a manner that arbitrarily deprived the petitioner of a reasonable opportunity to take the steps necessary to obtain a ruling on the propriety of filing supplementary materials after our remand order.[15]

WPDE argued that the Court's remand required the Commission to receive supplemental evidence. The Court flatly rejected this claim. Noting that its earlier remand was "based on the Commission's failure to offer an adequate explanation" for its conclusion that no hearing was required to dispose of WPDE's cumulative impact claim, the Court stated that a "remand for a 'statement of reasons' cannot be equated with an explicit directive either to reopen the record or to accept additional comments on the existing record."[16] The Court held that its remand instructions permitted, but did not require, a hearing. The Court agreed with the FCC's assessment that WPDE's cumulative impact claim could be disposed of on the existing record, holding that "the Commission was not required to reopen the record in order to comply with our mandate,"[17] and affirmed the Commission's decision not to afford a hearing.

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[14] 762 F.2d at 99.

[15] 762 F.2d at 101.

[16] 762 F.2d at 102.

[17] 762 F.2d at 104.

It is absolutely disingenuous for AT&T to cite *Eastern Carolinas* as support for its statement that "failure to consider new evidence or methodologies could itself provide a basis for reversal."[18] In *Eastern Carolinas* the Commission read section 402(h) as prohibiting it from receiving new evidence on remand absent an explicit directive by the Court.[19] The Court of Appeals did not disagree with that assessment, holding only that the Commission's interpretation of the statute was an unannounced change from prior agency practice, and that it was arbitrary and capricious for the agency to apply its new interpretation to the petitioner in that case.

AT&T also grossly misrepresents this Commission's holding in the *Spectrum Order*.[20] AT&T claims that a Court remand "for further explanation" has been interpreted by the Commission as enabling it "to examine in this rulemaking proceeding any public interest considerations that are relevant to the specific issues remanded by the court."[21] In fact, in the *Spectrum Order* case the Court's remand expressly authorized the Commission "to conduct 'further proceedings consistent with this opinion.'"[22] It was this grant of authority, not a remand "for further explanation", that authorized the Commission to receive additional evidence.

In *Greater Boston*, Judge Leventhal discussed Section 402(h) and Congress' intent in adopting that section:

> . . . Congress, on July 16, 1952, amended 47 U.S.C. § 402 by adding subsection (h), providing that in the event of a court decision reversing an order and remanding the case to the FCC "to carry out the judgment of the court" the FCC had the duty "unless otherwise ordered by the court, to do so upon the basis of the

[18] AT&T Comments at 19.

[19] The Commission's interpretation of the scope of Section 402(h) in *Eastern Carolinas* remains binding on the Commission and the parties to this proceeding unless and until superceded.

[20] In the Matter of Amendment of Parts 2, 22 and 25 of the Commission's Rules to Allocate Spectrum for and to Establish Other Rules and Policies Pertaining to the Use of Radio Frequencies in a Land Mobile Satellite Service for the Provision of Various Common Carrier Services, 7 FCC Rcd 266 (1992) ("*Spectrum Order*").

[21] AT&T Comments at 19 (citing *Spectrum Order*, ¶ 28.)

[22] *Spectrum Order*, ¶ 28.

> proceedings already had and the record which said appeal was heard and determined." The Committee report stated that the addition was "intended to confer upon the appellate court a measure of control commensurate with the dignity and responsibility of that tribunal."[23]

The Court noted that Section 402(h) was "passed to restrict FCC latitude to reopen the record in case of reversal."[24] The Court explained that once a petition for review has been filed in Court, "the FCC has no authority to conduct further proceedings without the court's approval."[25] Thus, only in the case of a remand, and only to the extent authorized by the Court, is the Commission free to revise its order under review. Here the Court identified the issues that the Commission could consider on remand, and instructed the Commission to "provide further explanation" for its decision. It did not authorize the Commission to reopen the record, to consider new methodologies not presented to the Court, or to reopen issues finally decided in the case. AT&T's creative reading of the law notwithstanding, the Commission is limited for the remand period to applying the 1997 Staff TFP Study and explaining its choice of an X-Factor from the record presented to the Court.

Ad Hoc also claims that the Commission not only can, but must, consider additional evidence, including the two new staff studies, on remand. Ad Hoc cites a generalized treatise on administrative law for this proposition, ignoring the specific statute applicable to the Commission.[26] Like others advocating reliance on the reverse-engineered staff studies in the FNPRM, Ad Hoc claims that the Court did not limit what the Commission may consider on

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[23] *Greater Boston*, 463 F.2d at 281-282.

[24] 463 F.2d at 282.

[25] 463 F.2d at 283.

[26] *Greater Boston*, 463 F.2d at 287: "[P]recedents pertaining to other agencies are not necessarily fungible, and each case calls for analysis of the statutory system governing the agency in order to ascertain how Congress has balanced the interests of flexibility and finality."

remand.[27] That, of course, stands the law on its head. Under Section 402(h), the Commission may ONLY consider new evidence on remand when so instructed by the Court. Section 402(h) clearly instructs the Commission "to forthwith give effect" to the Court's order "and unless otherwise ordered by the court, to do so upon the basis of the proceedings already had and the record upon which said appeal was heard and determined." It is hard to imagine a more clear statutory command. The construction of the statute urged by AT&T and Ad Hoc would essentially read Section 402(h) out of the Act. Reliance upon the 1999 Staff TFP Study or the Staff Imputed X Study for the remand period would constitute clear reversible error.

The Appropriate Response to the Remand.

The law requires the Commission to apply its 1997 Staff TFP Study in an even-handed manner for the remand period, supplying a reasoned explanation for the choices made in response to the Court's order. As BellSouth demonstrated in its opening Comments, a straightforward application of the 1997 Staff TFP Study reflects an achieved X-Factor of 4.86 percent for the 1991-95 period.[28] If the Commission finds that it is authorized to update the 1997 Staff TFP study to look at the results for later years, the achieved X-Factor for the entire price cap period, 1991-98, is 4.12 percent. The achieved X-Factor for the most recent five year period, 1994-98, is 4.06 percent.[29] The Commission should prescribe the historical component of the X-Factor from within this range of values.

[27] Ad Hoc at 4. *See also*, MCI at 4: "Similarly, there is no legal restriction on the Commission that would prevent its considering data beyond that examined in its original 1997 decision. In its remand, the court set no limit on the Commission's ability to examine any relevant data."

[28] This equates to the 5.22 percent X-Factor presented to the Court of Appeals, supplemented with updated and revised BLS data. BellSouth Comments at 17.

[29] BellSouth Comments at 17.

If the Commission prescribes an historical X-Factor from the record that was before the Court, the issue of a "reinitialization" becomes moot. Since the record supports an X-Factor below 5 percent, and since virtually all price cap LECs elected an X-Factor in 1996 of 5.3 percent, there is no need or justification for a "reinitialization." In any event, the record does not support the continuation of the CPD to reflect increased productivity due to the elimination of sharing. As BellSouth demonstrated in its opening comments, substantially all of the price cap LECs opted for the "no-sharing" option in 1995 or 1996. Thus, if the elimination of sharing caused an increase in productivity, it would have shown up in the historical X-Factors calculated for 1996-98. As the record reflects, the achieved X-Factors for those years was 1.98 percent, 3.62 percent and 3.03 percent, respectively.[30] There is no factual basis to retain a CPD based on the elimination of sharing.[31]

Despite these facts, Ad Hoc and AT&T attempt to justify not only the retention, but an increase in the CPD, due to the elimination of sharing.[32] Both AT&T and Ad Hoc make the same fundamental flaw of logic in attempting to justify a CPD as a result of the elimination of sharing. Both assert that the Commission can estimate the increased productivity that the LECs would achieve from the elimination of sharing by performing a calculation that starts with the

[30] BellSouth Comments at 17-19.

[31] See GSA at 14: "In GSA's view, it may never be possible to specify an analytically defensible procedure for determination of the appropriate CPD."

[32] AT&T claims that the Court held that "retention of the CPD in some amount was appropriate" and therefore the only issue is the amount of the CPD. This simply misrepresents the Court's decision. In fact, in the very next paragraph to the one cited by AT&T the Court noted that the LECs claimed that the Commission had failed to justify "the retention of *any* CPD". The Court found it unnecessary to reach this argument by the LECs, however, because "the FCC will be able to give a clearer statement of its reasons in the remand on the amount..." Thus, the Commission has the burden of justifying the retention of a CPD, and if it seeks to do so, to justify the amount of the CPD. This was clearly acknowledged at page 11 of the FNPRM: "Alternatively, is the CPD no longer necessary because the approach described here sufficiently passes the benefits of increased efficiency to ratepayers?"

percentage increase in efficiency incentives estimated by Strategic Policy Research to result from the elimination of sharing. This is a blatant comparison of "apples" and "oranges". The fact that elimination of sharing may provide LECs with additional efficiency incentives does not imply that those incentives can automatically be translated into achieved productivity gains.[33] It simply says the LECs will have greater incentives to try to achieve such gains.[34] The Court clearly recognized that it is the actual increase in productivity, not increases in incentives, that the CPD is designed to capture.[35] As BellSouth demonstrated in its opening Comments, and as AT&T's own studies demonstrate, the LECs achieved productivity gains have declined post-1995, when sharing was eliminated for virtually all price cap LECs. Thus, if there was any stimulation in achieved productivity as a result of the elimination of sharing, it was more than offset by other factors.[36] In any event, the achieved productivity gain, if any, is fully reflected in the actual

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[33] AT&T attempts to "assume" away the problem. In Appendix C, page 2, AT&T asserts: "If we further assume that the LEC's potential productivity gain...is a linear function of the incentive for efficiency...." AT&T makes no attempt to justify, much less prove, this assumption. But its conclusion admittedly depends on the truth of this assumption: "And if that is so, the change from a price cap system with sharing to one without sharing should ultimately produce a much larger productivity increase -- about three times as much (94/29) -- as the change from the old ROR system to price caps with sharing." (Emphasis added).

[34] AT&T concedes that neither the SPR study nor the Ad Hoc study "attempts to measure directly the impact on productivity of the elimination of sharing." AT&T at 21. Two paragraphs later, AT&T misrepresents the SPR study by implying that it did just that: "The SPR model predicts that the change from the sharing system to a no-sharing system should produce productivity gains of about three times that amount -- i.e., 1.5 percent." AT&T at 21-22. The SPR model made no attempt to estimate actual productivity gains, and AT&T's misuse of the model to estimate achievable productivity gains is totally bogus.

[35] *USTA v. FCC*, 188 F.3d at 527: "[I]t is defensible to include a CPD corresponding to whatever productivity increase may be expected from the elimination of sharing." (Emphasis added).

[36] In its opening comments BellSouth identified a number of factors that accounted for productivity gains early in price caps that will not recur, thereby leading to lower productivity gains in the future. These included one-time force reductions, rate structures that generated more revenue from faster growing minutes rather than slower growing lines, relatively less competition, and the cost of implementing the 1996 Act. BellSouth Comments at 43-47.

productivity differential for the years following 1995, and an additional CPD would clearly double count this source of productivity growth.[37]

AT&T also commits a logical flaw in proposing a continuing CPD to account for the elimination of sharing. If the elimination of sharing did, in fact, spur additional productivity, it would have occurred in the years immediately following the elimination of sharing. A permanent CPD, however, compounds over time. Thus, if the elimination of sharing sparked additional productivity, a CPD for a one or two year period might be justified. However, there is no reason to assume that a one-time event, such as the elimination of sharing, would continue to spark additional productivity gains year after year. It would therefore be necessary to reverse the CPD out of the price cap indices at the end of the period in which the additional productivity was realized.

The existing price cap indices have embedded in them several percentage point reductions from CPDs from prior years. Unless the Commission reinitializes the PCIs to remove prior CPDs, they continue to drive down prices year after year. The CPD is thus a "gift that keeps on giving." There is no justification to impose new CPD adjustments to reflect the elimination of sharing. AT&T correctly notes that "the CPD itself should be used solely to compensate consumers for additional future productivity gains that are not captured in the

[37] This fact is recognized by AT&T at page 24 of its comments, where it acknowledges that "the historical component already reflects some years in which the LECs had no sharing obligations (either by election or by rule), Thus, the historical component may already reflect some of the efficiency gains associated with the elimination of sharing."

historical measure of productivity gains."[38] Once the historical record reflects the increased productivity gains, any reliance on a CPD is simply double-counting.[39]

In sum, the appropriate response to the Court's remand is for the Commission to reduce the X-Factor to 4.86 percent, eliminate the unnecessary "reinitialization" and eliminate any CPD. The Commission should craft an appropriate remedy for the price cap LECs to recoup the losses caused by the erroneous adoption of a 6.5 percent X-Factor in the *1997 Price Cap Performance Review*.

The Appropriate X-Factor Prospectively.

As BellSouth demonstrated above, while the Commission has very limited options regarding the evidence it may consider in responding to the Court's remand, it has considerably more flexibility in changing its rules for the future. A number of commenting parties urge the Commission to use this flexibility to raise the X-Factor prospectively. The Commission should not do so. Most of the parties urging such extreme action justify their position based on the assumption, either implicit or explicit, that rising LEC interstate book earnings are a "problem" that must be "fixed". To the contrary, the modest increases in LEC book earnings are simply evidence that price caps are performing as designed, and that the result is a "win-win" situation for the LECs and their interstate access customers.

LEC Price Caps have been a "Win-Win" for Carriers and Customers.

The application of the LEC price cap plan since 1990 has resulted in over $6 billion in interstate access charge reductions to the IXCs and large business customers. The end result has

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[38] AT&T at 24. "The CPD has never been used to correct past mistakes, and it should not be used for that purpose now."

[39] The same is true for any "q" adjustment. The historical TFP studies fully capture any economic effect of generating additional revenues due to per-minute pricing to recover non-traffic sensitive costs. A separate "q" factor is simply double-counting.

been that consumer prices for interstate toll services have risen at a rate substantially lower than other "utility" services over the past decade. The following chart from the Commission's latest "Trends in Telephone Service" makes this point dramatically clear.

Annual average rate of change PERIOD 1988 - 1998

CPI - All Items	3.1%
CPI - All services	3.8%
CPI - All Telephone Services	0.9%
CPI - Public Transport	4.1%
CPI - Piped Gas	1.9%
CPI - Electricity	1.3%
CPI - Water/Sewer	4.9%
CPI – Postage	2.8%
CPI - LOCAL TELEPHONE	1.6%
CPI - INTRASTATE TOLL	-0.7%
CPI - INTERSTATE TOLL	**0.06%**

TABLE 13.1 AND 13.3 "Trends in Telephone Service", FCC Industry Analysis Division, Common Carrier Bureau, September, 1999

LEC interstate access charge reductions have been significantly greater than the value represented in the CPI - Interstate Toll above. First, the CPI toll index underweights participation in high volume discount toll plans. Second, due to varying competition levels, business customers have received a disproportionate share of toll price benefits.

Consumers have been big winners from LEC price cap regulation not only in absolute terms, but relatively speaking as well. The vast majority of the efficiency gains from LEC price cap regulation have been flowed through to customers in the form of price reductions. USTA compared the earnings gains of price cap LECs with the rate reductions enjoyed by customers over the 1991-95 time period. In Attachment 2 to the USTA reply comments, USTA shows that LECs have kept, in the form of earnings gains, only 26.8 percent of the benefits of their improved efficiency during this period. Thus, over 70 percent of the efficiency gains generated by the price cap LECs have already been passed on to interstate access customers. The modest share retained by the LECs is an appropriate reward for generating these gains in the first place.[40]

USTA also examined the source of improved LEC earnings under price cap regulation. In its Reply Comments USTA demonstrates that the Commission's X-Factor rules have held LEC profit margins (operating income divided by revenues) essentially flat. By contrast, more than half of the rising earnings among competitive companies in 1990-95 period came from increasing profit margins.[41] The earnings gains realized by the price cap LECs have come almost exclusively from expense reductions and improved asset efficiencies (revenues divided by average net investment). This is precisely how the price cap incentive structure was designed to operate.

"Recapturing" LEC Earnings improvements would destroy price cap incentives.

Several commenting parties parrot the conclusion from the two new staff studies in the FNPRM that LEC earnings growth represents "excessive earnings" that must be recaptured for ratepayers. GSA, for example, overtly states that "the tabulation shows that the productivity offset does not accomplish the objective of constraining the interstate rate of return for major carriers under price cap regulation."[42] When did constraining earnings become an objective of price cap regulation? MCI asserts that rising LEC earnings make it "clear that the Commission

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[40] This estimate of customer's share of productivity gains is conservative. Booked interstate earnings are overstated due to depreciation practices, separations practices and how Internet traffic is booked.

[41] Teitelbaum, Richard S., "The Fortune 500. What's driving return on equity." *Fortune* magazine, April 29, 1996, p. 271 et seq.

[42] GSA at 6.

has been excessively conservative in setting the X Factor in the past."[43] By contrast, other parties recognize that the promise of improved earnings through improved efficiency is the engine that drives firms in competitive markets, and must be preserved if price cap regulation is to succeed. SBC notes:

> It is fundamental to this [price cap] system that LECs can rely with confidence on the promise that, when they outperform the prescribed productivity goals, they will be allowed to benefit from the profits their increased efficiency generates. Each time the Commission manufacturers a new reason to break that promise and deprive LECs of the rewards they have earned, the scheme is compromised, and LECs' future incentives are diminished.[44]

U S West states:

> Manipulating the X-factor to restrict LEC earnings undermines the very goal of price caps -- to encourage price cap LECs to operate more efficiently while maintaining or lowering rates. Even the suggestion of reinitializing price caps to reflect a new X-factor methodology calls into serious question the Commission's credibility and continued commitment to the regulatory compact of price caps.[45]

Iowa Telecom cites with particularity the impact that destroying the price cap incentive structure could have on smaller price cap LECs:

> [S]ome of the FCC's proposals set forth in the *Further Notice* could, if adopted, distort price cap regulation into a grotesque form of rate-of-return regulation that discourages economic efficiencies, which would be harmful to consumers in rural markets. Adoption of unfair price cap rules could well lead Iowa Telecom to join the ranks of many other LECs who have moved to rate-of-return regulation after a merger or acquisition.[46]

Both the Staff and the IXCs promoting increases in the X-Factor essentially ignore the impact on LEC incentives that would result from their proposals. The price cap LECs have invested hundreds of billions of dollars on the assumption that the Commission would keep its

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[43] MCI at 3.

[44] SBC at 9.

[45] U S West at 14-15.

[46] Iowa Telecom at 4.

part of the "regulatory bargain" and not attempt to recapture improved LEC earnings under price caps.[47] But that is overtly what is being proposed in the two new staff studies and the proposals of parties like AT&T. Indeed, when its own price cap plan was being considered by the Commission, AT&T correctly stated:

> The carrier will have considerably less incentive to increase its efficiency if any resulting improvement in its earnings must be passed through to rate payers.[48]

Later in the same docket, AT&T asserted that "continuing to focus on earnings, however, would seriously impair the success of a price cap system."[49] AT&T had it right then, and its proposals to recapture LEC earnings gains now is patently disingenuous. As Sprint notes in its Comments, "the proposals offered in the FNPRM – especially the imputed X study – will not only fail to move the industry to cost-based rates, but will actually result in a giant step backwards."[50] The Commission should stick to sound economics and refuse to attempt to recapture LEC earnings improvements.

BellSouth also notes that prospective "reinitializations" of the type advocated by AT&T are not benign. LECs cannot undo their investments in long-lived plant. They can, however, make future investment decisions based on the knowledge that their investment expectations are not being fulfilled by the Commission. Prospective reinitializations carry with them all of the

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[47] Despite repeated carping by the IXCs, the Commission has steadfastly refused to adjust the LECs' price cap plan because of the level of LEC earnings. *See* 1995 LEC Price Cap Performance Review, 10 FCC Rcd 8961, 9069 ¶ 245; 1997 Price Cap Performance Review, 12 FCC Rcd 16642, 16655-56 ¶ 25.

[48] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, AT&T Comments 10/19/87 at 25.

[49] Id., AT&T Comments 12/4/87 at 33.

[50] Sprint at 4.

damage to incentives of retroactive action, and destroy the expectation of regulatory constancy that is essential to the price cap incentive structure.[51]

The "Corrections" in the 1999 Staff TFP Study should not be made.

The comments of non-LEC parties demonstrate the fallacy of many of the so-called "corrections" to the 1997 Staff TFP Study that are proposed in the 1999 Staff TFP Study. With regard to the Staff's proposal to index changes in the cost of capital using Moody's Baa bond yields, Ad Hoc concedes that in principle "a method of calculating the cost of capital that takes into account the mix of debt and equity held by the price cap ILECs may yield a more accurate estimate of the trend in the cost of capital...."[52] Dr. Vander Weide demonstrated in his comments in support of USTA that when the market value weights of both debt and equity are considered, the downward trend in capital costs claimed in the 1999 Staff TFP Study essentially disappear. The Staff's proposal to recalculate LEC earnings for the years prior to price cap regulation was not supported by AT&T[53] or Ad Hoc.[54]

Even when non-LEC parties give lip service support to proposed "corrections" in the 1999 Staff TFP Study, they offer no analytical support for the proposals.[55] For example, in

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[51] In a September, 1997 "Review of Utility Regulation" by the Director General of Telecommunications of the British Office of Telecommunications, it was stated: "The DGT's ability to focus on the longer term has been particularly important in the capital intensive telecoms industry, where investments are made and returns earned over a long period. The investment climate needs to be stable and predictable in order for investors to make such commitments." www.oftel.gov.uk/history.htm

[52] Ad Hoc at 35.

[53] AT&T Appendix A at 7, noting that no adjustment to interstate earnings prior to 1990 is warranted "because interstate access services were under rate of return regulation prior to 1991."

[54] Ad Hoc at 15: "[T]he late 1980s are, for all relevant purposes, ancient history, and productivity experience during that time frame has little to no predictive value in the period embraced by the *Fourth Report and Order* and beyond."

[55] Ad Hoc asserts at 12: "While accounting rules typically treated these buyout costs as one-time charges against current earnings, from an economic perspective, these one-time costs, also referred to as 'excess benefits,' are exogenous non-recurring events properly removed from the historical analysis of TFP." The only support cited for this assertion is the FNPRM itself.

dealing with the Staff's proposal to disallow the LECs' "buyout" costs for force reductions, MCI states:

> [Employee buyouts and early retirement plans] have resulted in higher reported costs, as the LECs have in general taken one-time charges on their books to reflect these costs. If no adjustment to the LECs' labor expenses were made, LEC cost per employee would appear higher than it actually is, and LEC TFP would be improperly reduced.[56]

What is MCI suggesting? That the LECs didn't really make severance payments to the departing employees? Both the severance payments and the productivity gains due to force reductions are fully reflected in the historical TFP studies, and an attempt to disallow the severance payments while taking advantage of the resulting productivity gains would be patently arbitrary and capricious.[57]

Likewise, the proposal to use DEMS as the measure of local output receives support, but no critical analysis, from the advocates of a higher X-Factor. MCI notes that calls have been increasing in length since 1992, but makes no attempt to tie such increasingly long calls to an increase in LEC revenue.[58] Ad Hoc concedes that "under a flat-rated system, charges are not directly related to either the number of calls or the number of minutes."[59] Indeed, Ad Hoc implicitly supports the use of lines, not DEMS, as the measure of local output:

> A user's total traffic demand in terms of aggregate call duration, not the number of individual calls, will dictate the number of lines or trunks that the user requires.[60]

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[56] MCI at 9-10.

[57] AT&T is even more cynical than MCI. AT&T simply starts its analysis with "Option 2" taken as a given, with no attempt to justify the massive disallowance of LEC severance benefits. Its reason for ducking the severance issue is obvious. As BellSouth pointed out in its opening Comments, AT&T itself offered a comparable severance package to its own employees in 1996. Is AT&T now telling its shareholders that those payments were "excessive" or unnecessary?

[58] MCI at 9.

[59] Ad Hoc at 9.

[60] Ad Hoc at 9-10, footnote 21.

If demand drives the number of lines, why not simply use lines as the measure of local output, rather than a surrogate like DEMs? BellSouth compared the correlation of annual percent change between access lines, calls and local DEMs with local revenue to determine which measure more closely tracks local revenue. The correlation for 1986-1998 with local revenues was 0.35 for calls, 0.33 for local DEMs, and 0.75 for access lines. Thus, the correlation between access lines and local revenue was over twice as high as the correlation between local DEMs and local revenue. Reported local DEMs is also an imprecise figure. The Commission has recognized that many LECs in the past have not directly measured local DEMs when the charge for local service is flat-rated. The reported values for local DEMs therefore includes significant amounts of "estimated" minutes. The 1999 Staff TFP Study even uses an estimated 1998 value due to reporting lag. Access lines is a much more precise value. Therefore, if the Commission chooses to employ a single measure of local output, the most economically significant measure is access lines.

The so-called "corrections" to the 1997 Staff TFP Study advocated in the 1999 Staff TFP Study are not corrections at all, but simply artificial attempts to inflate the X-Factor. The Commission should continue to use the Court-approved 1997 Staff TFP Study to prescribe a future X-Factor.

The Staff Imputed X Study is entitled to no weight in the Commission's deliberations.

With the exception of GSA, whose stated objective is "to control the earnings of incumbent LECs," no party endorsed the use of the Staff Imputed X Study.[61] The reasons are obvious. The Staff Imputed X Study is simply a modification of the Historical Revenue Method

[61] GSA at 10.

previously rejected by the Commission because it represents a return to cost-of-service regulation. As Sprint commented:

> This is, quite simply, rate of return regulation! The Commission surely recognizes this fact, for it has **rejected the same idea** in the past for that very reason. In the *1997 Order*, the Commission declined to adopt what was then labeled the 'Historical Revenue Method'.[62]

As Bell Atlantic notes:

> In sum, the imputed X study resurrects a proposal already rejected by the Commission, uses economically meaningless criteria and them misapplies them. Rather than respond to the Court's concerns about a failure of a legitimate justification, the proposal compounds the Commission's earlier mistakes.[63]

Even AT&T and MCI, whose thirst for a higher X-Factor is unquenchable, cannot bring themselves to endorse the use of the Staff Imputed X Study to represcribe the X-Factor. AT&T elects to duck the issue with the statement that it "does not believe the Commission should adopt an entirely new methodology for calculating X-factors in this proceeding."[64] MCI relies on the Staff Imputed X Study to buttress its argument for a higher X-Factor than that produced by total company TFP analysis.[65] BellSouth has thoroughly refuted the Staff Imputed X Study in its opening Comments, and will not repeat that analysis here.[66] Suffice it to say that MCI offers no analysis of the study itself, simply parroting the staff's conclusions.[67] The Staff Imputed X-

[62] Sprint at 4. Sprint also stated at 5: "The imputed X study is nothing more than a retitled version of the previously rejected Historical Revenue Method. Application of the imputed X study would use a rate-of-return-based calculation to exacerbate the problems created by the current price cap regime, as well as deny the efficiency enhancing benefits that price caps promised. Such application should be rejected for the same reasons as its predecessor and more."

[63] Bell Atlantic at 9.

[64] AT&T at 12. AT&T then proceeds to propose its own "entirely new" methodology.

[65] MCI at 13.

[66] BellSouth at 35-41.

[67] MCI at 13.

Study is a repudiation of price cap regulation and is fundamentally flawed. It is entitled to no weight in the Commission's decision.

The Commission should reject calls for an "interstate only" measure of productivity.

MCI and AT&T continue their futile efforts to convince the Commission to adopt an "interstate only" measure of productivity. As BellSouth demonstrated above, the Court of Appeals rejected MCI's appeal on the "interstate only" issue, and the Commission's decision is now final and binding for the purposes of this case. In any event, MCI's arguments are simply a restatement of positions considered and rejected by the Commission and Courts in the past. They have not improved with age. MCI postulates that "if inputs are used in the same proportions in both intrastate and interstate services, this would imply that the X-Factor should be 3.5 percentage points higher than the Commission found for total company results."[68] This proposition is exactly the same one that AT&T advanced in the 1997 Performance Review, which was rejected by both the Commission[69] and the Court of Appeals.[70]

MCI treats the issue as a measurement problem. It is not a measurement problem. The "problem" is that, in economic terms, so-called "interstate productivity" simply does not exist. Since the production of both intrastate and interstate services utilize a common network, the notion of "interstate productivity" is economically meaningless, or, in the words of the Court of Appeals, not "economically well defined."[71] As Dr. Taylor points out:

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[68] MCI at 11.

[69] 1997 Price Cap Performance Review, 12 FCC Rcd at 16686-16687, para. 110.

[70] *USTA v. FCC*, 188 F.3d at 528: "AT&T offered claims of faster interstate productivity growth. It based these on an assumption of equal growth rates for interstate and intrastate inputs, but it offered no explanation why that assumption was economically justified, much less one so compelling that it would be error for the FCC to reject it."

[71] *USTA v. FCC*, 188 F.3d at 528: "[D]irect productivity measurement requires measurement of inputs, and there is no obviously meaningful way to segregate LEC interstate and intrastate

> Only in the case that the firm's production function is separable in those services – so that the marginal rates of substitution among interstate factors of production are independent of the levels of intrastate demand – can productivity growth for interstate and intrastate services be individually defined.[72]

AT&T's attempt to "adjust" the 1999 Staff TFP Study to generate an "interstate only" X-Factor fares no better.[73] AT&T starts with the 1999 Staff TFP Study, which BellSouth thoroughly discredited in its opening comments. AT&T then makes a number of adjustments and assumptions to try to derive an "interstate only" measure of productivity. Dr. Taylor addresses the theoretical shortcomings of AT&T's study in his reply comments on behalf of USTA, and BellSouth will not repeat his analysis here. BellSouth notes, however, that AT&T is again making arguments that have been considered and rejected by the Commission and the Court in the past. For example, in Appendix A, AT&T concedes that its approach is essentially the same as its "Performance-Based Model" previously submitted and rejected by the Commission and the Court.[74] AT&T also plays fast and loose with its cost of capital adjustment. It starts with the Commission's prescribed 11.25 percent rate of return in 1990. It then assumes that the LEC cost of capital declined in a linear fashion until it reached 8.63 percent in 1998. The 8.63 percent figure was based on an AT&T submission in another docket purporting to

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inputs because, as is undisputed, 'interstate and intrastate services are usually provided over common facilities.' *1997 Order* 12 FCC Rcd at 16,685, para. 107."

[72] Comments of W. E. Taylor on Behalf of U.S. Telephone Association, at 18, ¶ 35.

[73] As BellSouth noted earlier, AT&T's proposal was not part of the FNPRM, and therefore could not be adopted by the Commission without allowing parties an adequate opportunity to comment, which the truncated period for reply comments obviously is not. Further, AT&T did not put on the record the numerous factors that influence its study, such as a cost of capital methodology cross-referenced to another docket. Therefore, there is an inadequate record to evaluate AT&T's proposal.

[74] AT&T Appendix A at 8: "This is essentially the approach previously used by AT&T in its 'Performance-Based Model' to estimate interstate X-factors, based on the assumption that inputs grow at the same rates for interstate access as for the LECs' other regulated telephone services." The input growth assumption was expressly rejected by the Court of Appeals. *See USTA v. FCC*, 188 F.3d 521, 528 (D.C. Cir. 1999).

measure the Bell Operating Company cost of capital as of December, 1997.[75] To list just a few of the most obvious flaws in AT&T's approach:

1) AT&T's model did not produce an estimate of the LEC cost of capital at 11.25 percent in 1990. While that is the cost of capital prescribed by the Commission, AT&T's model produced a much lower estimate. Thus, by comparing its model output with the Commission's prescribed rate of return, AT&T assumes a much steeper decline in the cost of capital than its own model would support;

2) AT&T assumes a linear decline in the cost of capital. Any cost of capital analyst would reject such an assumption out of hand;

3) AT&T cuts off its cost of capital analysis filed in the represcription docket at the end of 1997. Its data therefore is more than two years old; and

4) AT&T's low-ball estimate of the cost of capital is inconsistent with its own prior submissions to the Commission. In an ex parte submission to the Commission in January, 1999, AT&T touted a rate of return of 10.57 percent.[76] Clearly, AT&T's submission is fundamentally flawed, both theoretically and through its selection of inputs. The Commission cannot afford any weight to AT&T's proposal.

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[75] AT&T Appendix A at 7.

[76] *See* January 27, 1999 letter from Brian Masterson of AT&T to the FCC, CC Docket No. 96-262, 94-1 and 97-250).

Conclusion.

In both its opening comments and in these reply comments, BellSouth demonstrates that the Commission has limited responsibility and authority to respond to the Court's remand. The Commission's 1997 Staff TFP Study, which was unchallenged before the Court, must form the basis for the selection of the X-Factor for the remand period. That study does not support an X-Factor remotely approaching the 6.5 percent prescribed by the Commission.

Under these circumstances, the Commission's best alternative is to adopt the CALLS proposal. This avoids the need to substantially reduce the X-Factor and to create a remedy for the inflated X-Factor for the remand period.

If the Commission does not adopt the CALLS proposal, it must reduce the X-Factor to no more than 4.86 percent for the remand period. Because of the declining trend in productivity improvements, and the reduced prospect for productivity gains that outstrip the economy as a whole in the future, the Commission should prescribe a future X-Factor of no more than four percent.

Respectfully submitted,

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January 24, 2000

CERTIFICATE OF SERVICE

I hereby certify that I have this 24th day of January, 2000, served the following parties to this action with a copy of the foregoing **REPLY COMMENTS OF BELLSOUTH**, reference CC Docket No. 94-1 and CC Docket No. 96-262, by hand delivery or by placing a true and correct copy of the same in the United States Mail, postage prepaid, addressed to the parties on the shown below:

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January 24, 2000